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No. 73

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In the Supreme Court of the United States

OCTOBER TERM, 1962

PEOPLE OF THE STATE OF CALIFORNIA AND PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Petitioners,

vs.

FEDERAL POWER COMMISSION, PHILLIPS PETROLEUM COMPANY,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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Reply Brief for Petitioners

In accordance with Rule 41(3) of the Revised Rules of the Supreme Court of the United States, the petitioners, the People of the State of California and the Public Utilities Commission of the State of California (California), submit this brief in reply to the brief for the respondent Federal Power Commission (Commission), and to the brief for the respondent Phillips Petroleum Company (Phillips).

ARGUMENT

I.

A Lawful Method of Regulation Cannot Be Discarded Now for Another Method Which May or May Not Become Effective at Some Uncertain Time in the Future

This controversy involves the exercise of unsolicited administrative action, affirmed by the Court of Appeals, whereby the Commission, though judicially commanded to regulate the rates of independent producers of natural gas, ceased to regulate those rates under lawful procedures, issugd the Policy Statement by administrative fiat as an interim substitute for regulation, and directed the energies of its personnel to exploring the concept of natural gas priced as a commodity on an area basis. Whether the Commission ever establishes area rate regulation (in some form or other), or whether, if established, such a scheme is approved or cast aside upon appeal, the method remains at the moment only a vision. Yet far from visionary have been the immediate consequences of the Commission's pursuit in the instant case of this long range objective.

The Commission, through its *Phillips* opinion, rejected the individual company cost of service approach for producer regulation (R. 256-269) and elected to be guided by a statement of prices established without notice, hearing or the taking of evidence (R. 325). A lawful and established means of evaluating producers' rates—designed to protect both the consumer and the industry—was abandoned, a temporary method fraught with legal and practical infirmities was substituted, and consumer interests were placed in abeyance to await the result of the area rate experiment.

California cannot comhrepend why the Commission did not follow conventional procedures in this *Phillips* case. The Commission, if so inclined, might have decided this matter with a finding that the rates at issue were just and reasonable, leaving those parties aggrieved by such finding to seek review. At the same time, while continuing to regulate producers on a cost

of service basis, it might have conducted proceedings relative to area rates—giving notice, requesting comment, holding hearings and taking evidence. No rejection of existing procedures would have been necessary; no Policy Statement would have been required. The Commission, instead, chose the unconventional course of termination without decision and of regulation by decree.

The explanation offered by the Commission for its unorthodoxy is an asserted obligation to devote its energies and those of its staff to the development of the new technique. (Com'n Br., pp. 32, 44). While it is not known how many staff members actually are engaged in the area program, California, as a sister regulatory commission, is aware of the enormous work-loads which sometimes are placed upon agency personnel. Nevertheless, a need for additional personnel certainly could have been anticipated sometime during the period from this Court's mandate to regulate in 1954 to the issuance of the opinion in 1960. A concurrent area rate investigation might even have been initiated with a limited staff at an earlier date. Moreover, if a vigorous program of regulation along conventional lines had been instituted in 1954 there might be no need today for staff assignments in the area rate field. (Calif. Br., pp. 23-29). Whatever the case, the Commission's shift in employees' duties cannot justify now the very acts which prompted the change—the rejection of cost of service and the promulgation of the Policy Statement.

If the Commission's concept of ultimately pricing gas as a commodity materializes, the question of whether such is a proper method of regulation under the Natural Gas Act and the *Hope*[1] case unquestionably will be before the courts. (Com'n Br., pp. 17-25). However, the present the realities of the situation prohibit directing all attention to the final end which the Commission desires. For if it is assumed, for purposes of argument, that the area price method is neither finally adopted nor approved, the Commission will have wasted irreplaceable time and resources

1 *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

to the detriment of the consumers who were entitled to continuous regulation. Even assuming that the area rate objective finally is attained, where will this leave the consumers who were denied lawful regulation during the interim period of development?

There is an important and yet unanswered question: With the commodity pricing of gas still only a notion, why did the Commission abandon years of experience with lawful and established procedures and proclaim a form of regulation by administrative fiat which prejudges the outcome of the commodity approach?

The Commission's brief makes no attempt to reply to California's arguments that the Policy Statement is fraught with legal and practical infirmities which make it an unlawful and ineffective form of regulation. (Calif. Br., pp. 48-55). Rather, the Commission asserts that it could not effectively regulate under existing procedures and that *something* had to be improvised for interim use until area rates were developed upon records in proceedings designed for that purpose. (Com'n Br., pp. 25-30, 35-37).

The Commission offers several reasons for its immediate abandonment of cost of service regulation. They are: (1) the absence of a correlation between a producer's investment input and his marketable output (Com'n Br., pp. 25-27); (2) the possibility that royalty owners might lease only to high cost producers (Com'n Br., p. 27); (3) the chance that gas from the same well might sell at varying prices depending upon who is selling the gas (Com'n Br., pp. 27-28); (4) the difficulties of allocating production and exploration costs between gas and oil (Com'n Br., pp. 28-29); (5) the futility of a cost approach when estimates of reserves are imprecise and income tax problems are complex (Com'n Br., p. 29, note 16); and (6) the administrative burden of holding repeated rate cases for each of the thousands of producers (Com'n Br., p. 29).

All of the above, with the possible exception of (6), are issues which the Commission and the courts have resolved in numerous pipeline company rate cases where questions of production as well

as transmission of natural gas were presented. See *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581 (1945). The issues (1), (2) and (3) are based on erroneous facts and unsupported assumptions (Calif. Br., pp. 42-44), and are concerned not with the Commission's broad responsibilities but rather with relationship problems which may or may not develop among co-producers and royalty owners. Phillips, the party that might have been expected to raise these issues, is conspicuously silent respecting them.

There remains for further consideration the alleged administrative burden of cost of service regulation. First, the examiner found that "the length and complexity of the instant *Phillips* proceeding cannot fairly be regarded as representative of the situation which will be commonly encountered in future rate proceedings * * *." (R. 65). Secondly, since the issuance of the *Phillips* opinion, the Commission and its examiners have continued to use the cost of service approach, in cases pending at the time of the opinion, with no indication of undue hardship. (Calif. Br., pp. 40-42). As one examiner recently expressed himself in such a proceeding:

> "The valuable lessons will flow directly from the fact that individual cases, through a more thorough churning of facts, claims and counterclaims, will enable the Commission to sort things out; make them clear; and keep them simple. Moreover, action in individual cases makes regulation a present reality rather than a distant hope, with each new case being approached with a background of progress and greater perspective." *Gulf Oil Corp.*, Docket No. G-9520, September 24, 1962 (Mimeo, p. 6).

Finally, any administrative burden in rate cases can be met by an application of self-help, such as requiring uniform accounts and records, as California has urged,[2] and by the expedition of hearings and decisions.

2 Petition to Establish a Uniform System of Accounts and Records for Independent Producers of Natural Gas, Docket No. R-220, (Calif. Br., pp. 26-27).

The rejection of cost of service certainly cannot be substantiated on the record in this proceeding which was developed along such lines. Yet this rejection was the motivating factor in the Commission's order of termination. (Com'n Br., p. 31). If the Commission had recognized cost of service as an acceptable premise for determining Phillips' rates, then this case could have been decisively concluded. Clearly this record demanded such recognition.

The impact of the rejection of cost of service lies not only in the termination of this proceeding but also in the creation of a hiatus in producer regulation. If the Commission had directly substituted a lawfully established area rate program upon the abandonment of cost of service, then California could not complain, whatever be its opinion of such program. But for the Commission to abandon prematurely this existing procedure when commodity pricing was only a theory with divided support, was a serious error.

The significance of this error was compounded by the Commission's unexpected promulgation of the Policy Statement. Like the rejection of cost of service, the Policy Statement motivated the Commission's termination of the instant proceeding. Even the Commission itself would have found termination impossible unless some substitute was provided simultaneously whereby it could oversee Phillips' rates. (R. 325). Undoubtedly, this is why the court below, in affirming the act of termination, attached so much importance to the Policy Statement. (R. 421-426). Yet the Policy Statement, while influencing the Commission's order of termination, served also as an instrument enabling the Commission to abandon lawful cost of service regulation before a lawful new method had even been devised.

Until the opinion in the instant proceeding, rate matters under the Natural Gas Act were handled by the procedure of notice, hearing and the taking of evidence. With the Policy Statement the Commission for the first time set rates based on what in its opinion the prices should be and, admittedly, not on what was just and reasonable in the statutory sense. It was never intended that a regulatory agency should have such power. This Court has

stated strongly that agencies, at least in rate matters, cannot act in such omnipotent fashion. In *Interstate Commerce Commission v. Louisville & Nashville R.R.*, 227 U.S. 88 (1912), the agency set aside certain rates because it was of the *opinion* that the rates were unreasonable. On review, the Government urged that an order based on such opinion was conclusive even without substantial supporting evidence. This Court rejected the contention and stated, at page 91:

> "But the statute gave the right to a full hearing, and that conferred the privilege of introducing testimony, and at the same time imposed a duty of deciding in accordance with the facts proved. A finding without evidence is arbitrary and baseless. And if the government's contention is correct, it would mean that the Commission had a power possessed by no other officer, administrative body, or tribunal under our government. *It would mean that, where rights depended upon facts, the Commission could disregard all rules of evidence, and capriciously make findings by administrative fiat.* Such authority, however beneficiently exercised in one case, could be injuriously exerted in another, is inconsistent with rational justice, and comes under the Constitution's condemnation of all arbitrary exercise of power." (Emphasis supplied).

II.

Section 5(a) and Section 4(e) Are Both Designed to Reach Results which Afford Protection for Consumers

In this proceeding there is no need to make fine distinctions between the Section 5(a)[3] docket and the Section 4(e)[4] dockets. The record was developed on a consolidated basis to obtain information respecting all of Phillips' jurisdictional natural gas operations. The evidence was submitted without particular regard as to whether it pertained to the general rate investigation or to the specific rate increase filings included within that investigation.

3. 52 Stat. 823 (1938), 15 U.S.C. § 717d(a) (1958). (Calif. Br., App. A, p. 3).

4. 52 Stat. 823 (1938), 15 U.S.C. § 717c(e) (1958). (Calif. Br., App. A, p. 2).

There was nothing unusual in consolidating the dockets[5] because Sections 5(a) and 4(e) are similar in purpose. Even though in different parts of the Natural Gas Act, both provisions are designed to achieve the broad purpose of consumer protection. For example, in a recent case this Court was not persuaded to make a distinction between interim order procedure in a Section 5(a) proceeding where no refunds were involved and the same procedure under Section 4(e) where refunds had been ordered. *Federal Power Commission v. Tennessee Gas Transmission Co.*, U. S. (1962). California believes that this Court was declining to draw hairline technical distinctions where an overriding public interest was involved.

It must be conceded that there are no differences between the objectives of each statute so far as consumer interests are concerned. While there are differences in language and procedural detail, these differences vanish after the initiation of proceedings. Hearings are conducted in like manner; presentations and examinations are made in similar fashion.

Sometimes it is difficult to determine which provision is the authority for a Commission proceeding. In *Shell Oil Co.*, Docket No. RI61-515, certain producers filed for increased rates pursuant to Section 4. Such increases became effective. Somewhat earlier the Commission had rejected similar increases proposed by another producer. *The Pure Oil Co.*, 25 FPC 383 (1961), affirmed *The Pure Oil Co. v. Federal Power Commission*, 299 F.2d 370 (1962). One of the questions in the *Shell* proceeding, instituted by an order to show cause, was whether the Commission should reject the producers' filings on the basis of its *Pure* decision. When the proceeding commenced, there was obviously a hearing under Section 4(e), yet as the proceeding developed it took the form of a Section 5(a) investigation. It was never determined, because it was unnecessary to do so, whether the Commission was acting

5. It has, in fact, been a common practice of the Commission to consolidate Section 5(a) and Section 4(e) proceedings for purposes of hearing and decision.

under Section 4(e), as purported, or whether the show cause order was in fact issued under Section 5(a). In short, the distinctions and differences between the two sections disappear in most, if not all, cases when hearings or litigation commence.

Section 5(a) and Section 4(e) being similar in purpose, decisions in the form of findings and orders should ensue under both provisions.

The Commission and Phillips attach no such requirement to Section 5(a). They would have Section 5(a) interpreted so as to limit its scope to the fixing of future rates when existing rates are found to be unjust and unreasonable. (Com'n Br., p. 31; Phillips Br., pp. 29-30). California, of course, does not dispute the proposition that a finding of unjust and unreasonable is a condition precedent to the setting of future rates under the statute. But this proposition is not identical to the interpretation urged by the respondents.

Section 5(a) provides:

> "Whenever the Commission, after a hearing had upon its own motion or upon complaint by any State, municipality, State Commission, or gas distributing company, shall find that any rate * * * is unjust, unreasonable * * * the Commission shall determine the just and reasonable rate * * * to be thereafter observed and in force, and shall fix the same by order * * *."

California finds two facets to this provision. First, the Commission on its own motion, or upon complaint, investigates the existing rates of natural gas companies to determine their lawfulness; second, the Commission sets rates for the future if the investigated rates are found to be unjust and unreasonable. There is no dispute respecting the latter statement. It is to the former that the Commission and Phillips object.

Assuming the validity of this objection, the narrow interpretation would mean that the Commission reserves the right to terminate a Section 5(a) proceeding, as it did this proceeding, at any time and for any reason. For example, a State being of the opinion

that the existing rates of a natural gas company do not meet the standard of just and reasonable, may institute a complaint proceeding under the statute. The Commission then conducts a hearing and finally issues an order of termination supported by any number of reasons, but not based on a finding that the rates are just and reasonable. By this order of termination the protested rates are allowed nevertheless to remain in effect *as if* just and reasonable, but without a finding to that effect. If the State objects to the termination, the Commission's response would be that Section 5(a) compels it to act only when there is a finding of unjust and unreasonable rates and, since no such finding was made, termination of the proceeding was in order.

California's position is that such a situation initially calls for a finding relative to the justness and reasonableness of the protested rates. If these rates are just and reasonable, the complaint proceeding must be concluded with such a finding; if the same rates are unjust and unreasonable, a finding to that effect must be made, but with the Commission further obligated to fix rates for the future. Whichever the situation, the Commission must make a finding.

In this case the Commission argues that it was not obligated to do anything under Section 5(a) because no finding that Phillips' rates were unjust and unreasonable was made. The Commission is tying its own hands. Once instituted, this proceeding became no different from a Section 4(e) matter as far as the reaching of a result was concerned. Regardless of the section, the result reached must protect the consumers of natural gas. And under the Natural Gas Act consumers are not protected by orders of termination without findings relative to the rates at issue.

Somewhat indicative of the Commission's unusual approach and concept of its own requirements is its recent treatment of an omission to make a finding of justness and reasonableness in one of its opinions. In *El Paso Natural Gas Co.*, Docket Nos. G-4769, *et al.*, Opinion No. 366, issued October 19, 1962, the Commission, in deciding a rate proceeding covering a span of eight years,

omitted a precise statutory finding as to the justness and reasonableness of El Paso's past and existing rates. El Paso raised this issue in its petition for rehearing. In the order denying petitions for rehearing, issued December 7, 1962, the Commission corrected this deficiency in its findings: "[T]he proposed increased rates filed by El Paso, are excessive and unreasonable to the extent they reflect amounts of return and related taxes in excess of those allowed in our opinion and order No. 366, and should to that extent be disallowed at this time." This, at the very least, represents a current recognition of the necessity for findings consistent with the practice under the Natural Gas Act until the startling omission found in the instant *Phillips* case.

These questions logically present themselves: Would the Commission have committed error in the *El Paso* case by omitting the basic findings? Could the Commission have directed El Paso to make significant refunds absent these basic findings? If the Commission can be excused from its statutory duty as to findings in the instant case, can it not then be argued that the dispensation of such basic findings would excuse other findings as to other issues. Such a broad result has already been condemned by this Court. *Colorado-Wyoming Gas Co. v. Federal Power Commission*, 324 U.S. 626, 631, 634 (1945).

If it is the Commission's view that findings are mandatory in a Section 4(e) proceeding, then the Commission should offer some explanation for its contrary position respecting Section 5(a). Since both provisions are designed to accomplish the same purpose—consumer protection—specific findings should be required in both.

III.

The Reasons Advanced for the Termination of the Proceeding Are Without Merit

The Commission argues that there was no abuse of discretion in terminating the Section 5(a) docket. The gravamen is that the record was unreliable because it was based on the unworkable premise that Phillips' costs should be the sole determinant of price

and because it was seriously outdated, thus unsuitable for making a decision. (Com'n Br., pp. 30-48). While California believes the Commission's views on the cost of service are unsupportable (Calif. Br., pp. 42-44), the Commission's argument respecting the staleness of the record will be considered further.

California is asking only that the Section 5(a) investigation be concluded. The fact that it took almost three years from the end of the hearings to the issuance of the Commission's order of termination is not by itself an excuse for termination. If the record was stale, it should have been reopened so as to permit a decision on the lawfulness of Phillips' existing rates. The relief California is seeking is much different from a request to reopen a record after a decision has been made on the record.

Even if the Commission were correct in so viewing the record, it was error to allow the rates to be treated as if just and reasonable on that record. The proper action would have been to correct the record, not to terminate the proceeding. The parties to the proceeding were entitled to a decision on the issues they had litigated.

In *Minneapolis Gas Co. v. Federal Power Commission*, 294 F.2d 212, 214-215 (D.C. Cir. 1961), a similar attempt by the Commission to terminate a proceeding was rejected:

> "In the case at bar the Commission entered upon a hearing concerning the lawfulness of proposed rates under [Section 4(e)] of the [Natural Gas Act]. That hearing was actually conducted and concluded. All parties announced that they had no further evidence to present. The Examiner made findings of fact, reached conclusions, and rendered an initial decision. Under the Administrative Procedure Act [Sec. 8(a)] the initial decision was a final decision unless upon exceptions the Commission itself concluded otherwise. The Commission received and heard arguments on exceptions. Thereupon the Commission terminated the proceedings. It did not render a decision. * * *
>
> "We think the Commission cannot terminate a proceeding after it has actually conducted a hearing to the point of receiving an Examiner's initial decision, *without rendering a*

decision upon the issue presented, which is the lawfulness of the proposed rates." (Emphasis supplied)

The Commission's action in both *Minneapolis Gas* and the instant proceeding resulted in the termination of proceedings without a finding on the issue presented—the justness and reasonableness of rates. In both cases extensive hearings were conducted, briefs were ordered, initial decisions were issued, oral arguments were heard and, in each instance, the Commission terminated without a finding. In *Minneapolis Gas* the court found such action unlawful. The same judgment should have been made in the instant proceeding.

The Commission contends that the termination of the Section 4(e) dockets also was appropriate. The only issue here, in the Commission's view, was whether refunds should be ordered for the periods during which the rates were in effect. (Com'n Br., pp. 48-53). California's position is that no conclusion concerning refunds is valid, or even possible, without a prior conclusion respecting the justness and reasonableness of the rates. (Calif. Br., pp. 29-34).

Section 4(e) allows for hearings "concerning the lawfulness" of rates. According to Section 4(a),[6] lawful rates are just and reasonable rates. Section 4(e), then, is designed to *test* the lawfulness of rates. Its primary purpose is not, as the Commission suggests, to decide whether refunds should be ordered for "locked-in" periods.[7]

The provision for refunds is merely a means of accounting for amounts collected while the issue of justness and reasonableness is

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6. 52 Stat. 822 (1938), 15 U.S.C. § 717c(a) (1958). (Calif. Br. App. A, p. 1).

7. The "locked-in" period is an anomaly of the Natural Gas Act. It was the intention of Section 4(e) that a rate proceeding be handled "as speedily as possible." However, through administrative lag a rate increase filing is allowed to be superseded indefinitely by subsequent filings, thus creating the locked-in periods. When the Commission finally attempts to determine the lawfulness of the original filing, the significance of the rates contained therein pales in the light of the subsequent filings.

pending before the Commission. The primary purpose of Section 4(e) is to consider the lawfulness of filed rates. Until a decision on the lawfulness of the rates is made, the question of refunds is not before the Commission.

Nor does a conclusion that no refunds are required follow from the fact that Phillips' costs exceeded revenues in a particular test year. In *Hunt Oil Co.*, Docket Nos. G-9065, *et al.*, Opinion No. 365, issued October 17, 1962, a consolidated Sections 5(a) and 4(e) proceeding, the Commission remanded the case to its examiner and said: "Our examination of the record in this case convinces us that increased rates for specific sales cannot always be found to be just and reasonable solely on the basis of a comparison of individual company-wide costs with that company's revenues in a test year." (Mimeo, p. 5).

The Commission's termination of the instant consolidated proceeding seriously affects California. Both sections are imbued with the public interest declared by Congress and often expressed by this Court. California intervened in the instant case as a representative of that public interest. The Commission's act of termination, without determination of the issue of the lawfulness of rates, deprived California of its right to a decision and the public of its interest in the enforcement of the Natural Gas Act according to the dictates of Congress.

IV.

The Validity of Spiral Escalation Clauses Is an Issue Properly Before This Court

The Commission's order instituting this proceeding set down for resolution the issue of the validity of Phillips' spiral escalation clauses. (R. 32). California has preserved this issue in its exceptions (R. 232-233), its petition for rehearing (R. 367-370), and in the Court of Appeals (R. 426-427). The Commission and Phillips urge that the issue is not reviewable because no "final orders" have been entered in Docket Nos. G-11217 and G-10883

wherein Phillips' rate increase filings were predicated upon the alleged activation of Spiral escalation clauses. (Comm. Br., pp. 54-55; Phillips Br., pp. 44-45). This position ignores the fact that the Commission left open each docket for a final determination of the *extent* of the increase only and for "no other matter." (R. 329). Once the rates of the pipeline companies buying from Phillips are determined in other proceedings, the only issue remaining in these dockets is the proportionate *amount* of the increase Phillips is entitled to under its sales contracts. California is concerned here with the contractual basis for the increase. The Commission finally determined California's legal rights on this contract issue in this proceeding, and if review is denied on the issue California will have been deprived of an opportunity to be heard.

Review of administrative proceedings is not premised on the issuance of "final orders." In *Atlantic Seaboard Corp. v. Federal Power Commission*, 201 F.2d 568, 572 (4th Cir. 1953), the court said:

> "The commission argues that the order which we are asked to review is not a definitive or final order of the commission; but our power to review is not limited to final orders. Section 19(b) of the Natural Gas Act gives us power to review 'an order' of the commission upon the petition of a party aggrieved. We should not, of course, exercise the power to review mere preliminary or procedural orders or *orders which do not finally determine rights of the parties*." (Emphasis supplied).

Significantly, this Court, in *Columbia Broadcasting System, Inc. v. United States*, 316 U.S. 407, 425 (1942), said:

> "The ultimate test of reviewability is not to be found in an overrefined technique, but in the need of the review to protect from the irreparable injury threatened in the exceptional case by *administrative rulings which attach legal consequences to action taken in advance of other hearings and adjudications that may follow*, the results of which the regulations purport to control." (Emphasis supplied).

To refuse to review Phillips' spiral escalation clauses in this proceeding would indeed result in irreparable injury to the millions of California ratepayers whose rates would depend then on automatic and arbitrary adjustments and not on regulatory standards.

There was, of course, a "final order" in Docket No. G-10795. However, the Commission also would have review denied here. (Comm. Br., pp. 56-57). The importance of this docket is that the Commission therein did give legal effect to this filing even though based on a spiral escalation clause. If it so acted with one such clause, it follows that it acted in the same manner with the other clauses. While California has a special interest in the escalation clauses in the Phillips-El Paso contracts for gas which ultimately reaches California, nevertheless the action this Court takes relating to that docket would necessarily apply to the others. There is inconsistency in the Commission urging denial of review in two dockets where it says no "final orders" were issued and at the same time raising the identical contention in a docket where admittedly a "final order" was made.

Phillips further argues that California has not defined the public policy which spiral escalation clauses violate. (Phillips Br., p. 47). The Commission itself has defined that public policy and the authorities have been cited. (Calif. Br., pp. 58-60). These clauses are objectionable because they assume that an increase in the resale rates of a pipeline company should have some retroactive effect on the rates of the producer who has been supplying that pipeline company. Actually, an increase in the pipeline company's rates has no economic bearing on the factors which make for a just and reasonable producer rate. Once a sale is made, the price later charged by the buyer to his customer is immaterial to the seller. Moreover, by the use of spiral escalation clauses, a producer with highly profitable rates nevertheless is entitled to file for even higher rates through the triggering of such clauses. Where prices are so indefinitely established by contract, the Commission has a burdensome task of reviewing numerous rate filings which do not purport to be justified on any basis other than the

occurrence of fortuitous events, and consumers have an unhappy obligation of paying rates deliberately inflated by private contract.

The Commission and Phillips rely on *Phillips Petroleum Co. v. Federal Power Commission*, 227 F. 2d 470 (10th Cir. 1955), cert denied 350 U.S. 1005 (1956), and *Kerr-McGee Oil Industries, Inc. v. Federal Power Commission*, 260 F.2d 602 (10th Cir. 1958), to support the legality of spiral escalation clauses. (Comm. Br., p. 60; Phillips Br., p. 45). Certainly in both cases contracts containing such provisions were reviewed. However, the cases held only that the Commission could not treat as a new rate a rate already in effect on June 7, 1954 (the date when producers were brought under regulation). The issue of the validity of the clauses on public policy grounds was not before the court. Ironically, the Commission and Phillips contend that the issue is not present in the instant case yet, in the same breath, in urging this Court to uphold these clauses, they rely on cases where the issue was not even litigated.

Texas Gas Transmission Corp. v. Shell Oil Co., 363 U.S. 263 (1960), and *Warren Petroleum Corp. v. Federal Power Commission*, 282 F.2d 312 (10th Cir. 1960), likewise are not cases supporting indefinite escalation clauses but cases concerned with the question of whether the Commission's construction of the clauses was a matter within its expert knowledge. In *Atlantic Refining Co. v. Public Service Commission of the State of New York*, 360 U.S. 378 (1959), this Court did no more than point out, at page 391, that a proposed initial contract price might not be in keeping with the public interest because "its approval might result in a triggering of general price rises or an increase in the applicant's existing rates by reason of 'favored nation' clauses or otherwise * * *." This statement seems to support California's position on public policy rather than to aid the Commission and Phillips' defense of the clauses.

Remaining is the Commission's argument that rejection of filings based on the clauses might deprive Phillips and other

producers of contract rights. (Comm. Br., pp. 61-63). The argument is that Phillips may have accepted less favorable terms at the time the contracts were executed in return for the inclusion of the escalation clauses, and to strike these "bargained-for" provisions would be a "harsh" decision. While there is no record basis for the argument and Phillips itself does not raise it, California will add that any question as to the separability of the clauses from the contracts was answered when Phillips agreed to eliminate them in the future. (R. 327).

The Commission relies on *Southwestern Sugar & Molasses Co., Inc. v. River Terminals Corp.*, 360 U.S. 411 (1959), to support its argument. The *Southwestern Sugar* case is clearly distinguishable on facts and law from the instant proceeding. *Southwestern Sugar* did not concern administrative action but arose from a libel action by a shipper against a carrier for loss of uninsured cargo through negligence. The question was whether a shipper could recover damages from a carrier protected by an exculpatory clause. In the present case, the question is whether a particular contract clause is void in a regulatory setting. This case, then, involves regulatory action and not a question of damages before a court of law. Moreover, there is no similarity between the exculpatory clause which was not declared void in the *Southwestern Sugar* case and the spiral escalation clauses involved in this proceeding. The exculpatory clause operates to reduce rates to the benefit of the shipper and, as this Court recognized at page 418 of that decision, if the carrier were able to exact high rates and limit its liability at the same time the circumstances might be different. Spiral escalation clauses, on the other hand, operate to increase rates by allowing producers to file for increases at indefinite times and under indefinite conditions.

The implausibility of the Commission's position is evident from the following argument in its brief:

> "In the first place, if the Commission were to void all spiral escalation clauses, whenever executed (or if this Court, by its decision here, were to do so), it might well be inundated by rate filings of producers claiming, whether validly

> or otherwise, that the contracts were no longer in force and therefore no longer restrained them from filing for higher rates." (Comm. Br., p. 61).

This argument seems to assume a right of producers to file for rate increases unilaterally without contract support. There is a requirement that any rate increase application must be based on an agreement between the seller and buyer. *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 340 (1956). If the clauses are stricken the contract price might be that called for by the contract in the absence of the activation of the escalation clause, or the price on June 7, 1954. There can be no unrestrained filings as the Commission suggests.

Spiral escalation clauses were declared prospectively void less than a year after the Commission's opinion in this case. The Commission used this proceeding as a vehicle for rejecting cost of service and for promulgating the Policy Statement but, for some unexplained reason, refused to use it to declare spiral escalation clauses void for regulatory purposes.

V.

The Primary Question Presented Is Whether or Not the Commission Has Implemented This Court's Mandate to Regulate Producers of Natural Gas

The Court below characterized this case as one involving "major problems of general application" and posing "complicated procedural difficulties." (R. 414). This statement is recognition that not only is the regulation of a single natural gas producer involved, but also the regulation of producers generally. The instant case presents an opportunity to this Court, having ordered previously the regulation of producers under the Natural Gas Act, to decide whether or not the Commission is implementing that order.

The crux of California's complaint is that the Commission has not followed this Court's mandate. It is obvious that the regulation of pipeline prices was of dubious value when the

prices paid by the pipeline companies to the producers were unregulated. Yet the opinion of the Commission and the decision of the court below have caused such uncertainty in this producer price regulation as to raise the serious issue of whether this Court's mandate is being followed.

As producer regulation now stands, the Commission fluctuates between the Policy Statement, with the cost of service method rejected, and recent expressions seeming to favor cost of service. (Calif. Br., pp. 40-42).

This running from method to method is based upon a Commission concept of license to do so. Since the cost method is the antithesis of the Policy Statement method, it is apparent that one must be inconsistent with the Natural Gas Act, and in conflict with the mandate for effective producer regulation. The danger of this proceeding rests in the facts that the Commission assumes the right to regulate upon either basis, when in fact the Natural Gas Act is designed for cost regulation (Calif. Br., pp. 44-45) and the case law to date clearly indicates that costs are essential ingredients to producer regulation. (Calif. Br., pp. 35-42).

Phillips, however, would have this Court's review restricted to a few technical points. (Phillips Br., pp. 19-24). The analysis of the Court of Appeals is to the contrary, and the Commission itself does not urge such a restriction.

Phillips ignores the fact that this is the case in which the Commission was directed in 1954 to proceed to regulate independent producers. This Court is reviewing then the Commission's opinion in terms of compliance or noncompliance with its mandate. A complete review by this Court is not to be frustrated by a provincial approach which ignores the interest of the nation's consumers, particularly where that interest is charged with being subverted. This Court as a matter of law possesses jurisdiction for complete review upon the issue inherent in this case as to whether or not its directive is being followed.

The narrow review which only Phillips urges, and for the first time in this Court, can be traced to a misunderstanding of California's petition for rehearing of the Commission's opinion. In its

petition California did not think it proper to take a position on the validity of the proposed area rate program, and the Commission was advised that any arguments would be reserved for those proceedings wherein area rates were to be developed. (R. 363-364). However, California sought rehearing on grounds which included the contention that the Commission's general investigation of all of Phillips' rates was unlawfully terminated. Without question, the motivating factor behind this termination was the Commission's assertion that it could abandon presently lawful procedures and regulate on a temporary basis by administrative fiat until new procedures were lawfully constituted.

The issues which Phillips now wishes to have deleted were considered at length by the Court of Appeals and formed an integral part of the decision below. The matters raised by California are properly before this Court also by way of this Court's authority to review that decision.

Even if California had not filed a petition for rehearing, this Court might still review this matter. In *United States v. Abilene & S.R. Co.*, 265 U.S. 274 (1924), the Government appealed from a decree of a Federal District Court wherein the court refused to dismiss a suit to enjoin an order of the Interstate Commerce Commission even though no rehearing of the agency's order had been sought. This Court said, at page 282:

> "Despite the failure to apply for a rehearing, the court had jurisdiction to entertain this suit. * * * Whether it should have denied relief until all possible administrative remedies had been exhausted was a matter which called for the exercise of its judicial discretion. We cannot say that, in denying the motion to dismiss, the discretion was abused."

All issues raised by California are not only before this Court, but also they are deserving of this Court's complete review. This proceeding is no mere controversy as encountered in the traditional regulatory case. This Court looks, as it must, at the broad implications which lie beyond the legal assertions.

CONCLUSION

For each and all of the reasons stated herein as well as for the reasons stated in its Brief for Petitioners, California urges that the opinion of the Commission, and the decision of the Court of Appeals affirming the Commission, be set aside as unlawful, and that the proceeding be remanded to the Commission with directions to regulate the rates of Phillips, and of all other independent producers, in accordance with the Natural Gas Act and the original mandate of this Court.

Respectfully submitted,

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